

Message Text

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ACTION ARA-14

INFO OCT-01 ISO-00 SP-02 AID-05 EB-08 TRSE-00 SS-15
STR-07 OMB-01 CEA-01 CIAE-00 COME-00 FRB-03
INR-10 NSAE-00 XMB-02 OPIC-03 LAB-04 SIL-01 L-03
H-01 PA-01 SSO-00 NSCE-00 INRE-00 USIE-00 /082 W
-----086441 221733Z /40/65

O 212257Z MAR 78

FM AMEMBASSY LIMA

TO SECSTATE WASHDC IMMEDIATE 9235

C O N F I D E N T I A L SECTION 1 OF 2 LIMA 2464

C O R R E C T E D C O P Y FOR REFERENCE OMITTED IN ORIGINAL
TRANSMISSION:

E.O. 11652: GDS

TAGS: EFIN, EGEN, PE

SUBJECT: PERUVIAN FINANCIAL SITUATION

REF: (A) LIMA 2247, (B) LIMA 1953

1. SUMMARY: FINANCIAL CRISIS IS VIEWED HERE AS INCREASINGLY
SERIOUS AS PUBLIC BECOMES AWARE THAT GOP FAILING TO MEET IMF
STANDBY TARGETS. WIDESPREAD PERCEPTION IS THAT GOP INDECISIVE
AND CHANGES IN THE ECONOMIC TEAM NECESSARY TO END POLICY DRIFT.
IN CONTRAST, THERE IS LITTLE AGREEMENT ON WHAT SHOULD BE DONE
TO RECTIFY THE SITUATION. THERE IS BROAD OPPOSITION TO LETTING
EXCHANGE RATE FLOAT AGAIN, AND BANKING SYSTEM IS EXHORTING
GOP TO RELAX CREDIT RESTRAINTS, WHICH WOULD ONLY DEROGATE
FURTHER FROM IMF ACCORD. GOP OFFICIALS STILL TELL US PRIVATELY
THAT THEIR STRATEGY IS TO WORK OUT ELIGIBILITY FOR SECOND
TRANCHE OF IMF STANDBY BY EARLY MAY (SEE REF A) AND TO CONTINUE
NEGOTIATIONS ON THE DOLS 260 MILLION PRIVATE BANK PACKAGE IN
PARALLEL, BUT RUMORS GROW THAT INNER COUNCILS OF GOVERNMENT
ARE CONSIDERING ALTERNATE APPROACHES FOR RESTRUCTURING
DEBT. IN ANY EVENT, THE FINANCIAL SQUEEZE ON THIS
COUNTRY -- AND PARTICULARLY ON THE PRIVATE SECTOR --
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PROMISES TO GET VERY TIGHT IN THE WEEKS AHEAD AS DISPOSABLE
FOREIGN EXCHANGE RUNS OUT. THE GOP NEEDS TO TAKE QUICK
AND DECISIVE ACTION, BUT UNFORTUNATELY CONTINUES TO MOVE
SLOWLY, EVEN UNDER HEAVY PRESSURE. END SUMMARY.

2. THERE IS GROWING PUBLIC AWARENESS HERE THAT THE
FINANCIAL CRISIS IS APPROACHING A SHOWDOWN WHILE THE

GOP SEEMS UNWILLING OR UNABLE TO COME TO TERMS WITH THE IMF TO QUALIFY FOR THE SECOND TRANCHE DRAWING AND THUS PAVE THE WAY FOR THE VITAL DOLS 260 MILLION BALANCE OF PAYMENTS LOAN FROM FOREIGN COMMERCIAL BANKS. THE INDEPENDENT ENGLISH LANGUAGE LIMA TIMES ON MARCH 17 REPORTED THAT THE IMF SAYS PERU "HAS BROKEN THE STANDBY AGREEMENT AND IS THEREFORE NOT ELIGIBLE TO MAKE THE DRAWDOWN WHICH SHOULD HAVE BEEN AVAILABLE TO IT ANY TIME AFTER MARCH 1". THE OUTSPOKEN WEEKLY OIGA REPORTED DETAILS OF THE "EXTREMELY HARD AND UNREAL" PROGRAM PUT FORWARD LAST WEEK IN LIMA BY A NEW IMF DELEGATION HEADED BY JEAN VAN HOOTEN.

3. THE TWO PRINCIPAL PROBLEMS WITH THE IMF ACCORD ARE GENERALLY KNOWN, BUT THERE IS LITTLE AGREEMENT AS TO WHAT SHOULD BE DONE:

(A) EXCHANGE RATE STRUCTURE. GOP OFFICIALS STAUNCHLY MAINTAIN THAT THE 130 OFFICIAL RATE IS REASONABLE IF THE CURRENT CRISIS OF CONFIDENCE (MEANING, INER ALIA, UNCERTAINTY ABOUT THE IMF SECOND TRANCHE/DOLS 260 MILLION BANK LOAN) CAN BE OVERCOME. ON FRIDAY, MARCH 17, THE BANKS, CHAIRED BY THE QUASI-OFFICIAL BANCO DE LA NACION, AGREED TO EXTEND THE 130 RATE GENTLEMAN'S AGREEMENT THROUGH MARCH 31. PRIVATE BANKERS AND BUSINESSMEN ARE NEAR UNANIMOUS IN THAT THE RATE WILL HAVE TO GO UP SOONER OR LATER BUT ARE VERY NERVOUS ABOUT THE CONFIDENTIAL

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SHORT TERM IMPACT OF STILL HIGHER FOREIGN EXCHANGE COSTS ON HARD PRESSED FIRMS. THE MOST BROADLY HELD VIEW IN THE PRIVATE SECTOR IS THAT THE RATE SHOULD BE ALLOWED TO RISE GRADUALLY IN CONJUNCTION WITH AN IMMEDIATE RELAXATION OF CREDIT RESTRICTIONS SO THAT PAYMENTS FALLING DUE CAN BE PAID. THE LEADING PERUVIAN BANKS MET WITH FINANCE MINISTER SAENZ MARCH 16 AND AGAIN MARCH 17 IN AN ATTEMPT TO OBTAIN SOME AMELIORATION OF THE ALMOST 50 PCT OF HARD CURRENCY EXPORT RECEIPTS RETAINED BY THE GOP (TO MEET PUBLIC SECTOR OBLIGATIONS AND COMPLY WITH IMF NET RESERVE TARGETS) AND WERE REPORTEDLY TURNED DOWN FLAT ON BOTH OCCASIONS. ALVARO MENESES, KEY FIGURE IN NEGOTIATING DOLS 260 MILLION BANK PACKAGE CONFIDED TO US THE PROBABLY BEST COURSE ON EXCHANGE RATE WAS A RETURN TO MINI DEVALUATIONS BUT, WHEN REMINDED THAT THIS WOULD MEAN BASIC RENEGOTIATION OF IMF ACCORD WITH FURTHER DELAY, HE STATED THAT A RETURN TO A FLOATING RATE WAS ALSO FEASIBLE IF OTHER ELEMENTS COULD BE WORKED OUT. THE FACT IS THAT NOBODY KNOWS THAT WOULD REALLY HAPPEN AT THIS POINT IF THE OFFICIAL RATE WERE TO BE CUT LOOSE AGAIN. THERE ARE CLEARLY SOME LEAD/LAG EFFECTS WORKING AGAINST THE SOL: ANY IMPORTER THAT CAN GET DOLLARS AT

130 IS MAKING PAYMENTS AS QUICKLY AS HE CAN, AND THE WIDESPREAD UNCERTAINTY AND LACK OF CONFIDENCE IN THE GOP ECONOMIC TEAM IS ENCOURAGING A SCRAMBLE FOR DOLLARS AT THE CD RATE OF 160 OR MORE. LEAVING THESE SHORT TERM, SPECULATIVE FACTORS ASIDE, WE UNDERSTAND EVEN LINDA KOENIG FELT A CURRENT 130 RATE WAS NOT UNREASONABLE (ALTHOUGH WITH INFLATION AT 30 PERCENT PLUS, ANY RATE WOULD HAVE TO BE ADJUSTED UPWARD OVER TIME).

(B) NET BORROWING REQUIREMENT OF THE PUBLIC SECTOR. THIS APPEARS TO BE THE OTHER MAJOR PROBLEM WITH THE FUND AND CONSISTS OF A PROJECTED 17 BILLION SOL EXCESS ABOVE THE PROJECTED BORROWING REQUIREMENT FOR THE PUBLIC SECTOR IN 1978 OF 35 BILLION SOLES. SOME 8 OF THE 17 BILLION
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SOLES WAS A DIFFERENCE OF "INTERPRETATION" AS TO HOW ROLLOVER OF THE JANUARY SOVIET DEBT WOULD BE TREATED, ALTHOUGH THE GOP NOW APPARENTLY ACKNOWLEDGES THAT THE ENTIRE 17 BILLION GAP WOULD HAVE TO BE ADJUSTED THROUGH NEW MEASURES TO MAINTAIN THE AGREEMENT (SEE REF A). THIS GAP COULD BE RESOLVED IN PART BY AN INCREASE IN GASOLINE PRICES. WE ESTIMATE THAT A 25-PERCENT INCREASE IN GAS PRICES (A RELATIVELY MODEST ADJUSTMENT IN VIEW OF OVER 60 PERCENT INCREASE IN DOLLAR IMPORT PRICES SINCE THE LAST GAS PRICE RISE) WOULD PROVIDE ROUGHLY 6-7 BILLION SOLES IN ADDITIONAL REVENUES. PRESUMABLY THE GOP IS STUDYING OTHER TAX MEASURES AS WELL. THE KEY TO A GAS PRICE RISE IS TIMING AND, IN PARTICULAR, WHETHER SUCH AN ACTION CAN BE TAKEN IN TIME TO PERMIT EARLY MAY ELIGIBILITY FOR THE SECOND TRANCHE. OTHER QUESTIONS BEING RAISED PRIVATELY ABOUT FISCAL MEASURES ARE THE NEED FOR MORE EFFECTIVE TAX COLLECTION (FOR EXAMPLE, CORRUPTION IN THE ASSESSMENT OF IMPORT DUTIES IS A TRADITION) AND THE RELUCTANCE OF THE BUREAUCRACY TO TAKE ANY REALLY SIGNIFICANT CUTS IN ITS PROGRAMS.

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INR-10 NSAE-00 XMB-02 OPIC-03 LAB-04 SIL-01 L-03
H-01 PA-01 SSO-00 NSCE-00 INRE-00 USIE-00 /082 W
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O 212257Z MAR 78
FM AMEMBASSY LIMA
TO SECSTATE WASHDC IMMEDIATE 9236

C O N F I D E N T I A L SECTION 2 OF 2 LIMA 2464

4. BEYOND THE TWO CLEAR BREACHES IN THE IMF ACCORD --
EXCHANGE RATE FLOAT AND PUBLIC SECTOR DEFICIT -- THERE
IS A MORE FUNDAMENTAL SKEPTICISM GROWING HERE WHETHER
THE IMF ACCORD OF LAST OCTOBER IS AT ALL FEASIBLE IN
ITS CURRENT FORM. THE LIMA CPI FOR JAN-FEB 1978 ROSE
12.8 PERCENT AND, EVEN ACCEPTING THE SPECIAL FACTORS OF
THAT PERIOD, THE IMF TARGET OF 20 PERCENT FOR ALL OF
1978 NOW APPEARS CLEARLY UNATTAINABLE, WHILE A 30 PERCENT
PLUS RANGE IS WIDELY CITED. THIS COULD MEAN ADJUSTING
VARIOUS OTHER IMF TARGETS, INCLUDING WAGE ADJUSTMENTS.
CAN THESE BE CONSIDERED TECHNICAL ADJUSTMENTS OR IS A
NEW BASIC AGREEMENT CALLED FOR? SOME MORE KNOWLEDGABLE
BANKERS AND ECONOMISTS ARE CLARLY CALLING FOR THE
LATTER, AND LINK THIS TO A NEW GOVERNMENT ECONOMIC
TEAM THAT WOULD PUT THE WHOLE AUSTERITY/RECOVERY PROGRAM
ON A MORE RATIONAL, COMPREHENSIVE FOOTING.

5. ONE EXAMPLE OF SUCH AN ALTERNATIVE APPROACH WAS
MADE BY RAMON REMOLINA, LONG TIME CENTRAL BANKER AND RECENTLY
A PRIVATE MEMBER OF THE GOP TEAM IN NEW YORK NEGOTIATING
THE \$260 MILLION PACKAGE, BEFORE THE LIMA CHAMBER OF
COMMERCE ON MARCH 15. HE SUGGESTED:

(A) RETURN TO A FLOATING EXCHANGE RATE,
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(B) OPENING OF INVESTMENT TO NEW AREAS TO OIL
EXPLORATION AND MINING,

(C) ADDITIONAL INCENTIVES FOR NON-TRADITIONAL EXPORTS,

(D) RESTRICTIONS ON NON ESSENTIAL IMPORTS,

(E) ENCOURAGEMENT OF INTERNAL SAVINGS THROUGH
FLOATING OR INDEXED INTEREST RATES,

(F) MORE LIQUIDITY CHanneled TO THE PRIVATE SECTOR,

(G) IMMEDIATE NEGOTIATION BY THE GOP TO RESTRUCTURE THE EXTERNAL DEBT.

6. THE GOP STRATEGY AT THIS POINT IS INCREASINGLY AMBIGUOUS. THEY OFFICIALLY CONTINUE TO SUPPORT THE IMF ACCORD AND EXPLAIN TO US PRIVATELY THEIR SCHEDULE TO TAKE MEASURES IN COMING WEEKS SO AS TO BE ELIGIBLE FOR THE SECOND TRANCHE IN EARLY MAY AND THE \$260 MILLION LOAN SHORTLY THEREAFTER.

BUT CITIBANK REPRESENTATIVES TELL US THAT PERU COULD NOT POSSIBLY BE IN A POSITION TO DRAW UNTIL JUNE, AND THE ANDEAN REPORT QUOTES AN UNNAMED CENTRAL BANK ECONOMIST TO THE SAME EFFECT, ADDING THAT JULY WOULD BE A MORE REASONABLE TARGET DATE. THE ANDEAN REPORT ALSO ASSERTS THAT AS OF MARCH 6 THE CENTRAL BANK HAD A CASH POSITION OF ONLY \$80 MILLION, WITH SHORT TERM MATURITIES OF THE COMMERCIAL BANKS AND THE BANCO DE LA NACION OF \$279 MILLION COMING DUE THIS MONTH. THE PUBLICATION QUOTES A LOCAL BANK AS CALCULATING THAT BY MID-MAY THE COUNTRY WILL HAVE RUN OUT OF DISPOSABLE FOREIGN EXCHANGE. CONFIDENTIAL

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MEANWHILE, THE PRESIDENT AND OTHERS DECRY THE LACK OF UNDERSTANDING BY THE "OBSOLETE" FUND OF SOCIAL/POLITICAL REALITIES, AND THERE HAVE BEEN REPORTS OF CONTINGENCY PLANS UNDERWAY IN BOTH THE FINANCE MINISTRY AND THE PRESIDENT'S PRIVATE PLANNING BODY (COAP) FOR A DIFFERENT APPROACH FOR RESTRUCTURING THE FOREIGN DEBT. THE GOVERNMENT CONTROLLED DAILY LA PRENSA RAN A HEADLINE STORY MARCH 21 CAPPED "PERU MAY GO TO THE PARIS CLUB FOR ITS DEBT" (A WASHINGTON LATIN DATELINE STORY CITING INTERNATIONAL FINANCIAL SOURCES). THE ANDEAN REPORT STATES THAT "PERU PROBABLY STILL INTENDS TO CALL A PARIS CLUB MEETING TO ASK FOR A REFINANCING OR RESCHEDULING OF THE PAYMENTS DUE THIS YEAR WHICH ARE GUARANTEED OR PROVIDED BY FOREIGN GOVERNMENTS".

7. COMMENT: THE DRASTIC TURN IN PERU'S FINANCIAL AFFAIRS EVIDENTLY CAME AS A SHOCK TO AT LEAST MOST OF THE UPPER LEVEL OF THE GOP. THE GOVERNMENT KNEW THAT THE EXCHANGE RATE WOULD BE A PROBLEM WITH THE FUND, BUT SEEMED TO THINK IT COULD BE WORKED OUT AND THAT OTHERWISE PERU WAS PRETTY MUCH ON TARGET. THE ANDEAN REPORT ASSERTS THAT THE FINANCIAL AUTHORITIES TRIED TO JUGGLE THE BOOKS AND THAT THE FUND CAUGHT THEM AT IT.

8. THE NEXT FEW WEEKS WILL BE CRITICAL IN THIS PHASE OF THE PERU/IMF ACCORD. MORALES BERMUDEZ IS PLAYING THE ISSUE WITH THE SAME ELUSIVE STYLE HE HAS SO OFTEN USED. HE HAS RECENTLY TAKEN SEVERAL STEPS TO ALLEVIATE

PUBLIC POLITICAL PRESSURES -- INCLUDING AMNESTY FOR ALL
POLITICAL EXILES AND REINSTATEMENT OF FIRED LABOR
LEADERS ON HUNGER STRIKE -- IN THE FACE OF REPORTED
STRONG OPPOSITION FROM THE MORE CONSERVATIVE ELEMENTS
IN THE CABINET. THIS HAS BEEN INTERPRETED (AT LEAST
BY THE MARXIST WEEKLY MARKA) AS A NEW THIRD PHASE OF
THE PERUVIAN REVOLUTION BACK TOWARD THE REVOLUTIONARY
PRINCIPLES OF THE LEFT, WHICH WOULD IMPLY A CORRES-
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PONDING MORE RADICAL MOVE AWAY FROM THE IMF ACCORD FOR
DEALING WITH THE ECONOMIC CRISIS. ANOTHER INTERPRETA-
TION, IN CONTRAST, WOULD BE THAT WITH THE LEFT SOMEWHAT
MOLLIFIED (AND ALSO FRAGMENTED LARGELY AS A RESULT OF
MORALES BERMUDEZ'S DEFT HANDLING OF THE FEBRUARY 27-28
GENERAL STRIKE), HE IS IN A STRONGER POSITION TO TAKE
ON THE NEXT ROUND OF TOUGH ECONOMIC MEASURES, INCLUDING
THE POLITICALLY SENSITIVE GASOLINE PRICE RISE. TIMING,
HOWEVER, IS IMPORTANT, AND THE JUNE 4 CONSTITUENT
ASSEMBLY ELECTION IS AN ESSENTIAL POLITICAL TEST FOR THE
GOP.

9. THESE ALTERNATIVE SCENARIOS ARE OF COURSE SPECULA-
TIVE, AND WE CANNOT PROMISE ANY EARLY CLARIFICATION.
THIS GOP MOVES VERY SLOWLY, EVEN UNDER CONDITIONS OF
EXTREME URGENCY. IN ANY EVENT, THE IMF ACCORD HAS
TURNED OUT TO BE HARSHER THAN WAS ANTICI-
PATED LAST OCTOBER (FOR EXAMPLE, THE IMF PROJECTED AN
AVERAGE 110 EXCHANGE RATE FOR 1978), AND THERE IS NEAR
CONSENSUS IN PERUVIAN CIRCLES THAT A MORE GRADUAL PATH
BACK TO FINANCIAL BALANCE THROUGH A STRETCHED OUT DEBT
REPAYMENT SCHEDULE, IS JUSTIFIED. AT THE SAME TIME,
THE HIGH POLITICAL AND ECONOMIC COSTS OF DROPPING THE
IMF ACCORD AND GOING A DIFFERENT ROUTE TO MEET PRESSING
FINANCIAL NEEDS SHOULD ALSO BE CLEAR.
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Message Attributes

Automatic Decaptioning: Z
Capture Date: 01 jan 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: FINANCIAL CRISIS, ECONOMIC CONDITIONS, ECONOMIC REPORTS
Control Number: n/a
Copy: SINGLE
Draft Date: 21 mar 1978
Decaption Date: 20 Mar 2014
Decaption Note: 25 YEAR REVIEW
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 20 Mar 2014
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1978LIMA02464
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Expiration:
Film Number: D780125-0280
Format: TEL
From: LIMA
Handling Restrictions:
Image Path:
ISecure: 1
Legacy Key: link1978/newtext/t19780343/aaaabkkm.tel
Line Count: 318
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: 3cd260c3-c288-dd11-92da-001cc4696bcc
Office: ACTION ARA
Original Classification: CONFIDENTIAL
Original Handling Restrictions: ONLY
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 6
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: ONLY
Reference: n/a
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 20 jul 2005
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 3257939
Secure: OPEN
Status: NATIVE
Subject: PERUVIAN FINANCIAL SITUATION
TAGS: EFIN, EGEN, ECON, PE
To: STATE
Type: TE
vdkgvwkey: odbc://SAS/SAS.dbo.SAS_Docs/3cd260c3-c288-dd11-92da-001cc4696bcc
Review Markings:
Sheryl P. Walter
Declassified/Released
US Department of State
EO Systematic Review
20 Mar 2014
Markings: Sheryl P. Walter Declassified/Released US Department of State EO Systematic Review 20 Mar 2014